February 6, 2006

The Honorable A.G. Kawamura, Secretary
California Department of Food and Agriculture
1220 N Street
Sacramento, CA 95814

Dear Secretary Kawamura:

Dairy Institute of California is requesting that the Department call a hearing to consider changes to the Class 4a and Class 4b pricing formulas in Northern and Southern California. Dairy Institute is a trade association representing over 70 percent of the fluid milk, cultured milk products, and frozen dairy products processed in California, as well as approximately 65% of the cheese products manufactured in the state. The attached extracts of the Stabilization and Marketing Plans for Market Milk for the Northern and Southern California Marketing Areas contain proposed changes to Class 4a and Class 4b pricing formulas and comprise Dairy Institute's petition for this hearing. This hearing is being requested pursuant to Division 21, Part 3, Chapter 2, Article 4 through Article 9 of the Food and Agricultural Code, including Sections 61802 through 62079.

**Reasons why changes are needed:**

California's milk output continues to grow. Since January 1, 2000, milk production in the state has increased by an average of 3.6% per year, representing an average incremental volume of 1.2 billion pounds of milk annually. Currently, milk processing capacity in the state is near its maximum, but the current rate of milk production growth necessitates that the state add new plant capacity each year capable of handling 3.3 million pounds of milk per day. Currently, one new plant is being built in the South Valley area, but more capacity will be needed to deal with the growing milk supply.

Unfortunately, beyond the plant currently under construction, we know of no new plants that are even in the planning stages. The prospects for attracting new plant investment have been dimmed by the deteriorating business climate in California, especially as it relates to cheese plants. Business costs have continued to increase in the state, driving up the costs of manufacturing cheese, butter, nonfat dry milk, and whey products. Energy costs in particular have moved higher in the past two years. According to U.S. Department of Energy data, California industrial electric rates in October 2005 were 9.6% higher than they were for all of 2004, while California industrial natural gas rates in October were 47.6% higher. Labor costs continue to increase as well. Dairy Institute is

therefore proposing changes to the manufacturing costs allowances in the Class 4a and 4b formulas, pursuant to Sections 62062 and 62076(c) of the Food and Agricultural Code.

The cost of moving finished products to the market has increased in response to rising diesel fuel prices. Many customers for California butter and cheese are located east of the Rocky Mountains. As transportation costs have increased, California products have become less competitive in serving those customers. The current f.o.b. price adjusters no longer adequately reflect the relationship between California finished product prices and the national value of manufactured milk products. Pursuant to Section 62062 and 62076 of the Food and Agricultural Code, we are proposing adjustments to the f.o.b. adjustors for butter and cheese that are employed in the Class 4a and Class 4b pricing formulas.

Current cheese yields do not accurately reflect the yield of product attainable from standard composition producer milk. Consequently, we have proposed changes to the cheese yield employed in the Class 4b formula (Section 62076).

In past hearings, Dairy Institute has argued that dry whey should not be included in the Class 4b formula because the dry whey product is not representative of the utilization of the whey stream from California plants. Because of the tremendous diversity in California whey processing, there is no single whey product that would be broadly representative of California whey use. Furthermore, dry whey prices are not well correlated with all of the other whey product prices. This year, prices for various whey protein concentrates and isolates have been falling even as dry whey prices have continued to rise. As a result, plants that do not make dry whey have been facing shrinking margins. Even plants that produce dry whey have faced difficulties**.** The current dry whey manufacturing allowance of 20 cents per pound is below the cost of all three of the dry whey plants in the CDFA cost survey. The weighted average cost for dry whey plants in the CDFA survey was 26.73 cents per pound.

Addressing the dry whey issue is somewhat complicated. Sound economic and policy considerations, as well as an even-handed application of the principles CDFA employs for cheese, butter and nonfat dry milk, would support removal of dry whey from the 4b formula. However, the prevailing high dry whey prices make outright removal of dry whey from the pricing formula problematic because of the large and immediate negative impact on producer prices. The solution we advocate is a two-step proposal, where the first step is to increase the dry whey manufacturing allowance to the level of the weighted average dry whey manufacturing cost, as determined by the most recent CDFA cost survey. The second step is to permanently remove the dry whey factor from the 4b formula, which would occur immediately upon the first instance when the dry whey price falls below the proposed manufacturing allowance. Under this two-step approach, cheese plants get some immediate relief from the prevailing high whey prices, but the size of negative price impact on producers is reduced in comparison to the impact of the immediate removal of dry whey from the formula.

Our formula proposals utilize CDFA's most recent manufacturing cost studies, which are based on 2004 costs. However, we intend to amend our proposed make allowances when

manufacturing cost averages are updated by CDFA to reflect more current energy and labor rates. We decided to proceed with the petition before updated data became available because the severe, negative impact of the current formula on plant margins requires urgent action. Furthermore, it is anticipated that the updated data will be released before any potential hearing date resulting from this petition.

**Description of requested changes:**

The proposed changes to the Class 4a and Class 4b formulas are shown below:

**Class 4a**

Current Formula

Fat = (CME Butter Price - $0.0285 -$0.156) x 1.2
SNF= (CA NFDM Price -$0.152)

Proposed Formula

Fat = (CME Butter Price - $0.0147 -$0.156) x 1.2
SNF= (CA NFDM Price -$0.1543)

A change in the f.o.b. price adjuster for butter is proposed because new data released by CDFA suggest that California's weighted average prices for butter averaged $0.0147 less than the Chicago Mercantile Exchange (CME) Grade AA spot butter price during the August 2003 – July 2005 period. The proposed make allowance for butter is unchanged from the current formula, because the current make allowance covers approximately 75% of the butter manufactured in the state. We have maintained that the volume covered by the manufacturing allowance should be roughly equivalent across butter, nonfat dry milk, and cheese. Based on the March 2005 hearing decision, the butter make allowance was set higher than the weighted average cost in order maintain equivalent cost coverage with nonfat dry milk and cheese. We presume that equivalent cost coverage still requires that the butter make allowance be set above the weighted average manufacturing cost. The manufacturing allowance for nonfat dry milk we propose equals the most recent weighted average cost for making nonfat dry milk.

**Class 4b**

Current Formula

Cheese CWT = (CME 40# Cheddar Block Price -$0.029-$0.171) x 10.2
+ (CME Butter Price -$0.10 -$0.156) x 0.27
+ (Western Dry Whey Price - $0.20) x 5.8

Fat = Class 4a Fat Price
SNF = (Cheese CWT – (3.72 x Class 4b fat price))/8.8

Proposed Formula

1. *Initial Formula*

Cheese CWT = (CME 40# Cheddar Block Price -$0.0336 -$0.1769) x 10.0
+ (CME Butter Price -$0.10 -$0.156) x 0.27
+ (Western Dry Whey Price - $0.2673) x 5.8

Fat = Class 4a Fat Price
SNF = (Cheese CWT – (3.67 x Class 4b fat price))/8.78

2. *Permanent Formula (to be employed after the dry whey price falls to $0.2673 per pound or lower)*

Cheese CWT = (CME 40# Cheddar Block Price -$0.0336 -$0.1769) x 10.0
+ (CME Butter Price -$0.10 -$0.156) x 0.27

Fat = Class 4a Fat Price
SNF = (Cheese CWT – (3.67 x Class 4b fat price))/8.78

Our proposed changes involve increasing the f.o.b adjuster for cheese to reflect the average difference between California and CME cheddar cheese prices during the period June 2003 – May 2005. The proposed make allowances for cheddar cheese and dry whey are the weighted average manufacturing costs for cheese and dry whey from the most recent CDFA cost surveys. The cheddar cheese yield of 10 pounds per hundredweight of milk testing 3.67% fat and 8.78% solids not fat was obtained using the Van Slyke Cheddar Cheese Yield Formula. The component tests are the average for all California milk during the calendar year 2004.

Based on 2000-2005 commodity price data, the proposed changes would have decreased the Class 4b price by an average of 36 cents per hundredweight over the six-year period, while Class 4a prices would have increased by 4 cents per hundredweight. Dairy Institute requests that a hearing to consider our petition be called so that any changes resulting from the hearing could be implemented as soon as possible. Thank you for your consideration of our request.

Sincerely,

William Schiek
Economist

cc A. J. Yates, Undersecretary
Kelly Krug
David Ikari

**Northern and Southern California Stabilization and Marketing Plan (Plans 43 and 59), Proposed Changes:**

I. Article III - Class Prices

Section 300.0.

(D) The minimum prices to be paid for components used for Class 4a shall be computed as follows:

(1) For all milk fat, not less than the price per pound computed by the formula using the butter price, less an f.o.b. California price adjuster ~~of two and eighty five hundredths cents ($0.0285)~~ *one and forty-seven hundredths cents ($0.0147)*, less a manufacturing cost allowance of fifteen and six tenths cents ($0.156), and the result multiplied by a yield factor of one and two–tenths (1.2).

(2) For all milk solids-not-fat, not less than the price per pound computed by the formula using the nonfat dry milk price, less a manufacturing cost allowance of ~~fifteen and two tenths cents ($0.152)~~ *fifteen and forty-three hundredths cents ($0.1543)*, multiplied by a yield factor of one (1.0).

(3) The butter prices used in calculations pursuant to this Paragraph shall be the simple average of the Grade AA butter price quotations for the last significant trading action for sale, offer or bid at the Chicago Mercantile Exchange falling between the period beginning the 26th day of the previous month and concluding the 25th day of the current month.

(4) The nonfat dry milk prices used in calculations pursuant to this Paragraph shall be the weighted average price per pound for all Grade A and extra grade nonfat dry milk for human consumption sold f.o.b. California manufacturing plants for the period beginning the 26th day of the previous month and concluding the 25th day of the current month, as reported by the California Department of Food and Agriculture for the month.

(5) In the event that the Chicago Mercantile Exchange Grade AA butter price is not available to calculate the current Class 4a fat price, pursuant to Subparagraph (D)(1), then used in its place shall be the Chicago Mercantile Exchange Grade AA butter price used in the prior month's calculation of the Class 4a fat price. All other Paragraphs that use the Class 4a fat price shall operate as if the price had been established pursuant to Subparagraph (D)(1).

(6) In the event that the California weighted average nonfat dry milk price is not available to calculate the current Class 4a solids-not-fat component price, pursuant to Subparagraph (D)(2), then used in its place shall be the California weighted average nonfat dry milk price used in the prior month's calculation

of the Class 4a solids-not-fat price. All other Paragraphs that use the Class 4a solids-not-fat price shall operate as if the solids-not-fat price had been established pursuant to Subparagraph (D)(2).

(E) The minimum prices to be paid for components used for Class 4b shall be computed as follows:

(1) The Cheese hundredweight price shall be the price per hundredweight computed by the sum of the following:

(a) The price per hundredweight computed by the formula using the Cheddar cheese price, less an f.o.b. California price adjuster of ~~two and ninety hundredths cents ($0.0290)~~ *three and thirty-six hundredths cents ($0.0336)*, less a Cheddar cheese manufacturing cost allowance of seventeen and ~~one tenths cents ($0.171)~~ *sixty-nine hundredths cents ($0.1769)*, all multiplied by a yield factor of ten ~~and two-tenths (10.2)~~ *(10)*.

(b) The price per hundredweight computed by the formula using the butter price, less a manufacturing cost allowance of fifteen and six tenths cents ($0.156), less ten cents ($0.10), all multiplied by a yield factor of twenty-seven-hundredths (0.27).

(c) The price per hundredweight computed by the formula using the dry whey price, less a manufacturing cost allowance of twenty-*six and seventy-three hundredths* cents ~~($0.20)~~ *($0.2673)*, all multiplied by a yield factor of 5.8

(d) *If, in any month after May 2006, the dry whey price per pound computed pursuant to Subparagraph (E)(6) is less than or equal to twenty six and seventy-three hundredths cents ($0.2673), then for such month and every month thereafter, Subparagraph (E)(1)(c) shall cease to be applicable to the computation of minimum prices paid for components used for Class 4b and shall be removed from this Stabilization and Marketing Plan.*

(2) For all milk fat, not less than the price per pound computed pursuant to Subparagraph (D)(1) of this Section.

(3) For all milk solids-not-fat, not less than the price per pound computed by the formula using the Cheese hundredweight price established pursuant to Subparagraph (E)(1) less the product of three and ~~seventy-two~~ *sixty-seven* hundredths ~~(3.72)~~ *(3.67)* multiplied by the Class 4b fat price established pursuant to Subparagraph (E)(2), all divided by eight and ~~eighty~~ *seventy-eight* hundredths ~~(8.80)~~ *(8.78)*.

(4) The Cheddar cheese prices used in calculations pursuant this Paragraph shall be the simple average of the 40 pound block Cheddar cheese price quotations for the last significant trading action for sale, offer or bid at the Chicago Mercantile

Exchange falling between the period beginning the 26th day of the previous month and concluding the 25th day of the current month.

(5) The butter prices used in calculations pursuant this Paragraph shall be the simple average of the Grade AA butter price quotations for the last significant trading action for sale, offer or bid at the Chicago Mercantile Exchange falling between the period beginning the 26th day of the previous month and concluding the 25th day of the current month.

(6) The dry whey prices used in calculations pursuant to this Paragraph shall be the simple average of the Dry Whey – West Mostly prices as published in Dairy Market News between the period beginning the 26th day of the previous month and concluding the 25th day of the current month.

(7) In the event the Chicago Mercantile Exchange 40 pound block Cheddar cheese price is not available to calculate the Cheese hundredweight price, pursuant to Subparagraph (E)(1), then used in its place shall be the cheese price used in the prior month's calculation of the Cheese hundredweight price.

(8) In the event that the Chicago Mercantile Exchange Grade AA butter price is not available to calculate the Cheese hundredweight price, pursuant to Subparagraph (E)(1), then used in its place shall be the Grade AA butter price used in the prior month's calculation of the Cheese hundredweight price.

(9) In the event that the Dry Whey – West Mostly price is not available to calculate the Cheese hundredweight price, pursuant to Subparagraph (E)(1), then used in its place shall be the Dry Whey – West Mostly price used in the prior month's calculation of the Cheese hundredweight price.